Accounting

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What is the role of accounting?

There are many definitions of accounting, and many opinions about what the role of accounting is. The following definition is an attempt to describe the role of accounting: "Accounting is the art of recording, classifying, and summarizing in a significant manner and in terms of money, transaction and events which are in part at least, of a financial character and interpreting the results thereof." [1] Accounting could also be considered to be a service activity that supplies information to different interested parties. To sum up, there are many answers to the question what role does accounting have. For example:

- to describe the financial position of a company
- to describe the result of a company's business operations
- to provide information to different groups of people that have an interest in the company: eg, investors, customers, suppliers
- to provide information for decision-making within a company

One way of understanding the role and also the nature of accounting is by following the development of accounting through history.

The history of accounting

Many attempts have been made to locate the place where accounting was applied for the first time, with varying results. All results, however, indicate that accounting was first established in the ancient Egyptian, Chinese, Greek, Indian, and Roman civilizations. The reason that accounting was first taken into use in these civilizations is that the basic conditions that made the creation of accounting possible were also invented there. One of the inventions was the art of writing, which was necessary, since accounting is essentially a kind of recording. To be able to do the necessary calculations in accounting, the invention of arithmetic and the system of numerals was vital. The increase of private property in these civilizations required recording the facts related to these properties. Money was introduced in these civilizations as a result of commerce on

[1] Riahi-Belkaoui, Accounting Theory 4th edition, London 2000, p. 31-32

credit. When it became more common to use money in commerce (than earlier exchanges of goods) it also became more important to record the transactions. Increased worldwide commerce, which was a result of the development of more advanced ships, also required records. If commerce had remained on a small scale there would not have been as much pressure to create accounting as a means of monitoring business. With ever more widespread commerce, it became more common to do business through agencies or partnerships and the demand for records increased even more. [2]

The first system with double-entry bookkeeping as is used today, was done in Northern Italy in the 14th century. However, it is Lucas Pacioli that is usually associated with double-entry bookkeeping. His book "*Summa de Arithmetica, Geometrica, Proportioni et Proportionalita*" was published in Venice in 1494 and describes the double-entry bookkeeping method that was practised in Italy during this time.[3] Why double-entry bookkeeping? The concept that is used requires that there are two sides to every transaction. It is possible to get the same result in one column by using pluses and minuses as by using two columns with debit and credit. Negative numbers did not exist until the 16th century. For that reason, the T account was used to show an increase on one side and a decrease on the other side.[4]

The main characteristics of 15th century accounting were that the primary purpose for accounting was to give the owner information on his or her assets and liabilities. In most cases, there was no division between the finances of the owner and the company. Since the owner was involved in the day-to-day business there was not much need for a profit and loss report. Profit was usually calculated at the end of each business transaction instead of periodically. No accruals or depreciations were accounted. The accounting also included details of the weight, size and price of the goods. [5]

There have not been many changes in basic accounting theory since it was introduced in the 15th century. A few changes have been made to keep up with the changes in the business environment. As the business transactions became considerably larger, it became necessary to present a loss and profit report periodically instead of for each business transaction separately. As a result of industrialization, fixed assets became a big investment for a company and it became more important to account for depreciations.

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[2] Hendriksen & Van Breda, Accounting Theory 5th edition, USA, p 37
[3] Riahi-Belkaoui, Accounting Theory 4th edition, London 2000, p 3
[4] Hendriksen & Van Breda, Accounting Theory 5th edition, USA, p 33, 43
[5] Hendriksen & Van Breda, Accounting Theory 5th edition, USA, p 35-36

As investments grew larger it became important to report to investors. The investors played a significant role in financing investments. Consequently it became necessary to separate income as a return to investors, and income as a return to owners.[6]

Financial reporting is mainly what has changed over the years. Until the end of the 19th century, accounting was rather unregulated. Without regulation it was difficult for the investors of the company to make real assessments of different companies and those companies' ability to generate future profit. After the collapse of the American stock market in 1929 there were not many investors who wanted to risk buying shares in a company. They were afraid of getting misleading information or no information at all. The demand for a regulation of financial reporting arose. The purpose of the regulation was to re-establish trust in the stock market by securing the quality of the financial information. During this period many accounting theories were established to set a standard for accounting. [7]

The latest development in the accounting sphere is IFRS reporting. As the market has become more and more global over the years there has been a need to harmonize the accounting theories of different countries throughout the world in order to make companies' financial reporting comparable.

The elements of accounting

In accounting there are a few assumptions made. Some of them were presented in 1940 by Paton and Littleton and most of them are still applicable.

- The accounting unit that is accounted has to be clearly defined, usually a company.
- “The assumption of continuity” states that the accounting unit has an indefinite life
- The “balance equation” defines the following equation: Asset – liabilities = Equity.
- The accounting unit is a monetary unit, which means that all transactions are expressed in money.
- The accounting unit must be accounted in a stable monetary unit. It means that inflation should not be considered by accounting.
- Assets and liabilities have to be valued at acquisition values. This assumption does not apply in IFRS reporting, however.

[6] Hendriksen & Van Breda, Accounting Theory 5th edition, USA, p 44-47
[7] Hendriksen & Van Breda, Accounting Theory 5th edition, USA, p 65

- It must be possible to add up all costs to a value, as the product or asset is completed.
- All costs for an asset add up to the acquisition value of the asset.
- "The depreciation assumption" states that an asset is consumed during its economic life. [8]

Accounting is often divided into the accounting of business transactions and closure of accounts. Every day a number of business transactions are carried through that affect the financial position of the company. They need to be accounted on a regular basis. In accordance with the principle of double-entry bookkeeping, the sum of all debit-entries must be the same as the sum of all credit-entries when a business transaction is accounted. The principle states that assets increase on the debit side, liabilities increase on the credit side. Costs increase on the debit side and revenues increase on the credit side. In the following example, it is possible to see how different business transactions may be accounted.

- Sales of goods/services

Debit	Claims or bank funds increase
Credit	Revenues increase

- Purchase of goods/services

Debit	Costs increase
Credit	Liabilities increase or bank funds decrease

- Payment from customers

Debit	Bank funds increase
Credit	Claims decrease

- Payment to suppliers

Debit	Liabilities decrease
Credit	Bank funds decrease

Upon closure of accounts all the transactions of the financial period are summarized and presented in a balance sheet and a profit and loss statement. A balance sheet shows the financial position of a company at a certain point in time. The balance sheet has three main categories: assets, liabilities and equity.

[8] Falkman, Redovisningsteori, Lund 2000, p 24.

The assets are put on one side and the liabilities and the equity on the other side. The sum of the liabilities and the equity must always be the same as the sum of the assets according to the balance equation as described above. The balance equation is essential for accounting and is shown in *Figure 1*.

Assets	Equity
	Liabilities

Figure 1

The balance sheet shows the value of the assets in the company at a certain point in time. The assets are often divided in fixed and current assets. One must bear in mind though that a company could have other assets which are not always presented in the balance sheet such as goodwill and knowledge of the staff in the company. When accounting in accordance with IFRS principles, the assets will no longer be reported at the acquisition value but at the real value. With this method, the value of the assets in the balance sheet will perhaps be closer to the true value than before.

A liability could be described as a commitment that is expected to cause an outflow of assets in the future. The liabilities are usually divided up into long-term and current liabilities. The equity could be considered as funding of the assets in the company, which are the funds the owners have contributed to the company.[9] The equity is often classified as either restricted or non-restricted equity. The difference between the two categories is that the non-restricted equity can be used to pay dividends to the shareholders. The period result is a part of the non-restricted equity. In addition to liabilities and equity, there may also be provisions, which are a result of tax legislation. The provisions are a part of the profit that has not yet been taxed and must not be paid out to shareholders. Figure 2 is an example of a simplified balance sheet.

[9] Kellgren, Redovisning och beskattning, Lund 2004, p 44-47

BALANCE SHEET	
Assets	***Equity and liabilities***
Fixed assets	*Equity*
Current assets	Restricted equity
	Non-restricted equity
	Total equity
	Liabilities
	Long-term liabilities
	Current liabilities
	Total liabilities
Total assets	***Total equity and liabilities***

Figure 2

The profit and loss statement presents the company result over a period of time. It shows all revenues and costs for a period, i.e. how many resources the company has gained and used. Revenues can be defined as the increase of capital. Costs may be defined as the decrease of company capital. The result is the difference between revenues and costs.[10] *Figure 3* is an example of a simplified profit and loss statement.

PROFIT AND LOSS STATEMENT
Operating income
Operating costs
Operating surplus
Financial income
Financial costs
Earnings before tax
Appropriations
Tax
Profit/loss for the period/year

Figure 3

The accounts in the balance sheet and the profit and loss statement are usually put together in larger groups in an annual, or interim report. Accounts receivable is, for example, one item in a report even though it represents a group of accounts in the balance sheet.

[10] Falkman, Teori för redovisning, Lund 2000, p 76-80

Financial and management accounting

A distinction is often made between financial and management accounting, even though they often are based on the same information. In the beginning, there was no difference between them. The reason for this was that the accounting was of the greatest interest for the owner of the company, and he or she usually worked in the company and consequently had a good insight into the affairs of the company. For both financial accounting and management accounting the main purpose is to report the financial consequences of the business activities of a given period.

Financial accounting is the accounting that every company must carry out according to law – regardless of size and type of business. There are rules concerning how financial accounting must be recorded and presented. The purpose of financial accounting is usually to show the result and the financial position of the whole company which is usually done in an annual or interim report. The financial reporting information is, for example, used by investors to make a decision whether they want to invest their money in a certain company. There are also other groups of people that are interested in financial accounting: eg, customers and suppliers.

Management accounting can be defined as the accounting a company does in addition to the compulsory financial accounting. Unlike financial accounting, management accounting is voluntary. The most essential task for management accounting is to supply information that can be used by the company management, or other persons within the company, for decision making. The management in most cases is not satisfied by simply knowing the result of the whole company. For example, they may want to know why the result was good or bad and how the result was in various parts of the business. This is why it is essential to consider information requirements within the company when setting up management accounting.

Management accounting has been the driving force in the development of different charts of accounts for different types of businesses. This is also the case for the so-called variability-accounting, which states that while accounting a cost you should try to find the smallest variable.[11] By following this principle, it is possible to look at the results for various parts of the business and not simply the result for the whole company.
For financial accounting purposes, it is often sufficient that

[11] Karlsson, Introduktion till internredovisning, Lund 1998, p 26 f

accounts in the accounting are presented in groups. This is not always the case when it comes to management accounting. The information requirements in management accounting are often higher than in financial accounting, even though these requirements are not defined by law. Despite the difference between financial and management accounting, this difference is not always so obvious.

The connection between financial and management accounting can be arranged in different ways. It is, for example, possible to have the same charts of accounts and then add some accounts to fulfil the management accounting requirements. The charts of accounts may also be combined with other codes to distinguish different parts of the business from each other and so on. There is also a way to keep the different types of accounting totally separate from each other. The choice depends on the nature of the company. There is also another dimension to consider while establishing an accounting method. Accounting should also be designed in a way that it is easy to get the financial information for the tax return.

To sum up: irrespective of what type of accounting, it is essential that accounting is based on the requirements the recipient of the accounting information has – regardless of who he or she is. Accounting should not simply exist for its own sake. In that case, the information that is received from the accounting might not be of very much use.